

Before the Subcommittee on Telecommunications and Finance,
Committee on Energy and Commerce,
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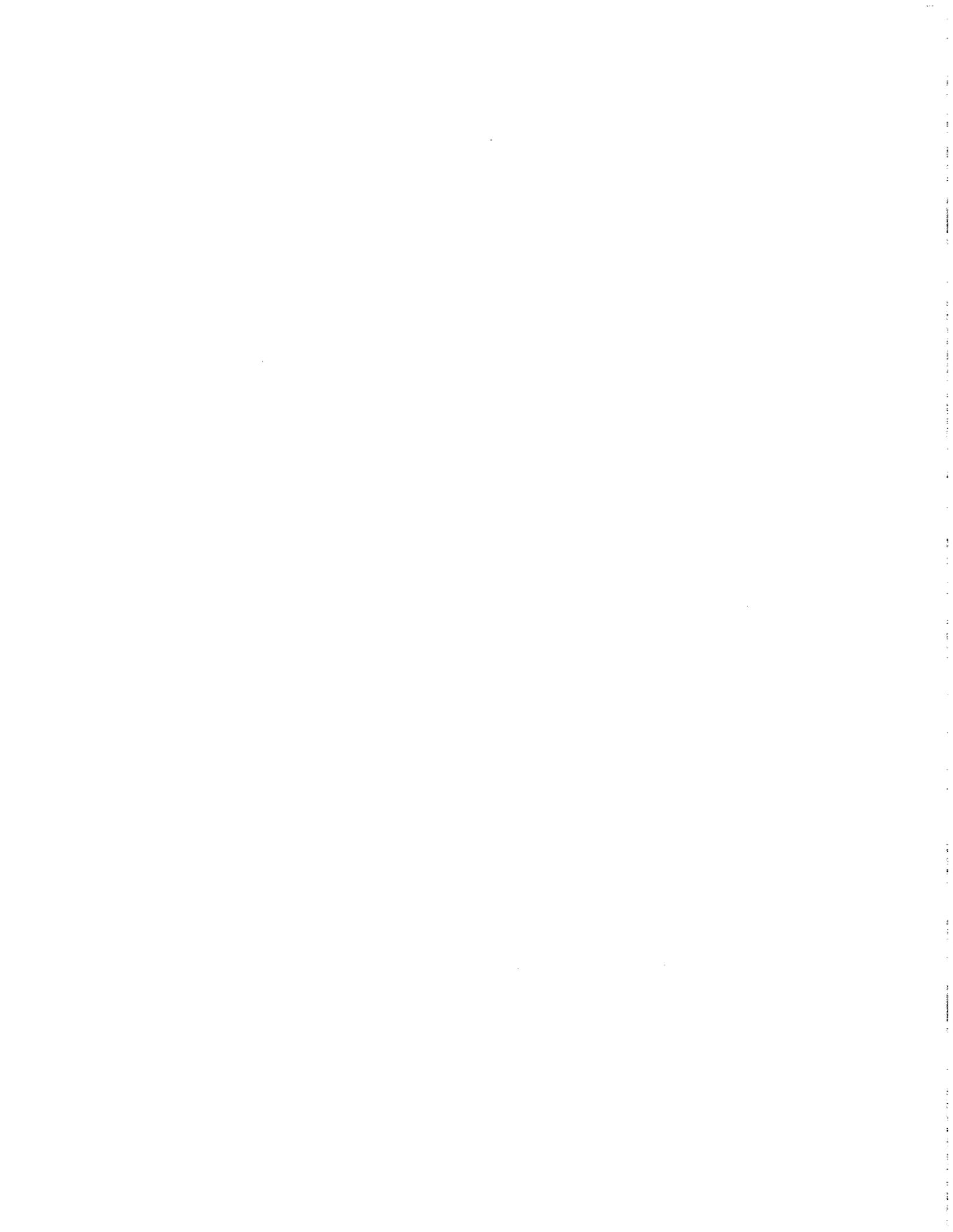
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ELECTRICITY SUPPLY

Regulation of the Changing Electric Utility Industry Under the Public Utility Holding Company Act

Statement for the Record of
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Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to provide this statement for the record. The statement presents preliminary findings from our ongoing review of the Securities and Exchange Commission's (SEC) administration of the Public Utility Holding Company Act of 1935 (PUHCA). My testimony addresses three of the issues that you asked us to review: (1) industry changes over the past decade involving electric utility holding companies, (2) SEC's regulatory response to such changes, and (3) the relationship between SEC, the Federal Energy Regulatory Commission (FERC), and states in protecting consumer and investor interests in light of these changes. Upon completion of our field work, we plan to issue a report on these issues. In summary, we have developed the following information to date:

- The electric utility industry has experienced several important changes in the past decade. These changes include the formation of a number of electric utility holding companies that are exempt from most PUHCA regulations; an increase in the number of nonutility subsidiaries of such exempt holding companies; and the emergence of independent power producers (IPPs), which are wholesale generators that are generally not part of a regulated electric utility.

- In response to these changes, SEC has continued to rely largely on state utility commissions to regulate exempt holding companies, as provided by the act. The agency has attempted to accommodate IPP development by advising potential IPP investors on the applicability of PUHCA restrictions. SEC has also developed and/or amended PUHCA rules, but none was intended to affect the industry's structure substantially.

-- SEC regulation of public utility holding companies, coupled with FERC and state regulation of utilities, is designed to protect consumer and investor interests. Among other things, SEC regulates utility acquisitions and certain securities transactions of holding companies. FERC does not directly regulate utility holding companies, but it does review transactions between utilities and affiliated companies, including IPP affiliates, in carrying out its regulatory functions. States regulate diversification activities and utility transactions involving IPPs, but the extent of their regulation varies.

PUBLIC UTILITY HOLDING COMPANY ACT

In 1935, Congress passed PUHCA to control and regulate utility holding companies.¹ The act's provisions were intended to protect the public, investors, and consumers from abuses associated with the control of electric and gas utility companies through the holding company structure. These abuses included subjecting subsidiary utilities to excessive charges for services, construction work, and materials, frustrating effective state regulation through the holding company structure, and overloading subsidiary utilities with debt so as to prevent voluntary rate reductions. The act directed SEC to reorganize the corporate structure of these holding companies and provide for the continued surveillance of the corporate structure, financial transactions, and operational practices of public utility holding companies.

Under PUHCA, all utility holding companies must file with SEC to become either a registered or exempt holding company. Those that

¹The act defines a holding company as "* * * any company which directly or indirectly owns, controls, or holds with power to vote, 10 per centum or more of the outstanding voting securities of a public-utility company or of a company which is a holding company * * *."

do not qualify for an exemption are called "registered holding companies" and are subject to extensive SEC oversight. In addition, they must limit their utility operations to a single area or region of the country, and any nonutility interest must be related to their utility operations.

Utility holding companies qualifying for an exemption, called "exempt holding companies," are free from most, but not all, SEC regulation. Exempt companies, for example, must obtain SEC approval before acquiring other utilities. Virtually all exempt holding companies obtain their exempt status for one of two reasons: (1) the holding company and its utility subsidiaries operate predominantly in one state or (2) the holding company is predominantly a utility. SEC may revoke a company's exemption if it determines that such action is warranted in the interests of the public, investors, or consumers. Since the act's passage, SEC has revoked the exemptions of one electric utility holding company (in 1945) and one gas utility holding company (in 1981). States and their utility commissions are responsible for regulating utilities and monitoring activities of exempt utility holding companies through rate proceedings and other means.

CHANGES IN THE ELECTRIC UTILITY INDUSTRY

Two significant developments involving electric utility holding companies occurred during the past decade. First, a number of utilities formed utility holding companies, qualified for an exemption, and diversified into nonutility-related businesses. According to industry analysts, many electric utilities experienced surplus earnings, resulting from a slowdown in power plant construction and decline in the rate of growth in electricity demand. This situation presented utilities and utility holding companies with the opportunity to diversify into nonutility-related businesses.

While the number of registered electric utility holding companies remained at 10 in the past decade, the number of exempt electric utility holding companies increased from 45 to 97.² This growth occurred in many states throughout the country, with the number of states having at least one exempt utility holding company growing from 23 to 35. The majority of the growth in exempt holding companies resulted from electric utilities reorganizing and forming "parent" holding companies for diversification purposes.³ Among other things, this type of holding company structure enables the holding company to separate its utility and nonutility businesses, thereby insulating the utility from potential financial risks associated with the nonutility interests.

Unlike registered holding companies, which may only acquire utility-related businesses, exempt companies have diversified into a variety of nonutility-related businesses, including finance, real estate, agriculture, telecommunications, and cable television. In the past decade, the number of nonutility subsidiaries of exempt holding companies grew from 113 to 1,040. This nonutility growth, however, was concentrated in a few states and companies. For example, based on data in SEC's 1989 report, one exempt holding company in California, two in Florida, and one in New York accounted for about 40 percent of all the nonutility subsidiaries.

The number of nonutility subsidiaries, itself, provides only part of the diversification picture. A holding company may own only a few nonutility subsidiaries, but they may be significant ventures

²Calculations are based on data contained in SEC's 1980 and 1989 Financial and Corporate Reports for registered holding companies and its 1979 and 1989 Financial and Corporate Reports for exempt holding companies. SEC's 1989 reports were the most recent ones available at the time of our review.

³We use the term "parent" holding company to refer to those companies that are exempt under PUHCA because they and their utility subsidiaries operate predominantly in one state.

in terms of their assets or revenues. For instance, a utility holding company in California owned 101 nonutility subsidiaries, which accounted for about \$970 million in assets. In comparison, a utility holding company in Arizona owned 32 nonutility subsidiaries, but they accounted for about \$9 billion in assets. Based on data in SEC's 1989 report, nonutility subsidiaries of exempt companies with a "parent" holding company structure had about \$37 billion in assets, or about 24 percent of the total assets of such holding companies, and about \$19 billion in revenues, or about 28 percent of the total revenues of such holding companies.⁴

Advocates of diversification hold that as a corporate strategy it could lead to improved earning prospects for investors and reduce a utility's cost of capital if such activity is successful. However, it could also adversely affect the rate consumers pay for electricity by increasing the utility's cost of capital if the nonutility investments fail. Other potential detriments include diverting management expertise away from the utility to the nonutility businesses or decreasing the reliability of utility service. For example, security ratings of an electric utility in Arizona and one in Florida were lowered because of financial difficulties experienced by their "parent" holding companies, thus increasing the utilities' cost of future borrowing. The financial difficulties of the utility holding companies were due in part to their unsuccessful diversification activities.

In addition, utility holding companies and other companies have developed IPPs to provide wholesale power to regulated utilities. IPPs have emerged as utilities have increasingly turned to purchasing wholesale power, instead of generating it themselves, to meet increases in demand for electric power. Numerous

⁴These totals include gas, electric, as well as gas and electric utility holding companies.

nonutility generators exist; unlike others, IPPs are considered to be electric utilities under PUHCA. Five IPPs are currently operating and 38 are under development, according to data contained in a 1991 report commissioned by the National Independent Energy Producers.⁵

Because IPPs are considered electric utilities under PUHCA and are commonly financed using a holding company structure, companies that own or operate them must either register under the act or seek an exemption. PUHCA generally precludes both registered and exempt utility holding companies from owning or operating IPPs in states located outside their operating areas. The act similarly deters other companies, such as engineering and construction firms with electrical expertise, from owning or operating IPPs: such companies would be defined under the act as electric utility holding companies, thus limiting their ability to develop additional IPPs and engage in other business activities.

Despite this deterrent effect, IPPs have been developed in ways that enable utility holding and other companies to own a portion of them without invoking PUHCA restrictions. For example, utility holding companies and other companies have developed IPPs by organizing a limited partnership, in which the limited partner invests in the project but relinquishes its right to control the day-to-day operations of the project to the general partner. The limited partner gains the economic benefits of IPP ownership without meeting the act's definition of a utility holding company. However, the general partner is subject to PUHCA because it controls the IPP and therefore meets the definition of a utility holding company. Other business structures have been used to develop IPPs, but none are completely free from PUHCA since the

⁵The National Independent Energy Producers is an association of companies that generate electricity for sale to utilities and develop cogeneration projects for a variety of users.

company controlling the IPP meets the definition of a utility holding company.

SEC RESPONSE TO
INDUSTRY CHANGES

Although the number of exempt utility holding companies and their nonutility subsidiaries has grown, SEC has continued to rely largely on state utility commissions to regulate these companies, as provided in the act. PUHCA does not expressly prohibit exempt companies from diversifying into nonutility-related businesses. However, SEC may deny an exemption to a holding company or revoke a holding company's existing exemption if it determines that diversification activities are or could be detrimental to public, consumer, or investor interests. SEC staff told us that they monitor exempt holding companies by contacting the companies themselves and reviewing their annual filings, as well as by reviewing industry publications and contacting other federal and state regulators.

SEC has never revoked a holding company's exemption for diversification reasons, nor has it clearly defined the extent to which an exempt company may diversify before endangering its exempt status.⁶ However, SEC has dealt with the diversification issue in other ways. In 1986, SEC staff reviewed the exemptions of four holding companies because of their diversification activities. SEC staff decided not to recommend formal action against these companies, but rather decided to develop a rule establishing diversification standards for exempt holding companies. In 1989, SEC proposed a rule to clarify the

⁶In a 1973 case, four SEC commissioners considered whether an exempt holding company's diversification into nonutility businesses made its continued exemption detrimental to consumer and investor interests. The commissioners, however, were unable to reach an agreement on the issue, and the company retained its exemption.

appropriate standards for permitting diversification by exempt holding companies.⁷ However, an SEC official said that comments on the proposed rule from industry officials, state regulators, and others were generally unfavorable. For instance, the National Association of Regulatory Utility Commissioners recommended that the proposed rule be withdrawn, in part because states can monitor diversification efforts and prevent abuses through their rate-making authority, police power, or by enacting specific legislation. SEC has not yet acted on the proposed rule.

SEC has attempted to accommodate IPP development within the confines of PUHCA and facilitated IPPs where the law permits. SEC staff have advised developers with respect to the formation of IPPs through no-action letters. A no-action letter is an informal way of informing developers that their IPP projects, if financed and developed as proposed, will not warrant SEC enforcement action under PUHCA. IPP developers request no-action letters by submitting a letter presenting how the IPP will be constructed and operated, including the companies involved and their financial interest in the project. According to SEC staff, they have issued six no-action letters on IPPs since 1986 and have declined to issue such a letter in one case. For example, SEC issued a no-action letter to the companies using a limited partnership to develop an IPP. In the letter, SEC staff recommended no enforcement action because the developer became a general partner and circumstances indicated that the limited partners would not exercise such a controlling influence as to warrant regulation as a holding company.

While utility and nonutility companies have invested in IPPs without invoking PUHCA regulations, the companies controlling these projects have not escaped the act. These companies, like

⁷The proposed rule would only apply to exempt utility holding companies having a "parent" holding company structure.

other utility holding companies, are required to register or seek an exemption under the act. As a result, these companies are subject to SEC regulation like other utility holding companies.

In addition to the increase in exempt holding companies and the advent of IPPs, other industry developments prompted SEC to make a number of rule changes. For example, the substantial increase in service company activities⁸ prompted SEC to amend a rule extending the filing date of the annual reports by service companies. In light of technological changes in record keeping and changes in related SEC, FERC, and state regulations, SEC amended a rule concerning the preservation and destruction of records of registered holding companies and their service companies. None of these changes, however, was intended to affect substantially the structure of the electric utility industry.

SEC, FERC, AND STATE REGULATION OF
UTILITY HOLDING COMPANIES AND
UTILITIES

SEC regulation of public utility holding company systems, coupled with FERC and state regulation of utilities, is designed to protect consumer and investor interests. SEC does not directly regulate utilities per se, but its enforcement of PUHCA is intended to facilitate FERC and state regulation of utility rates and operations by restricting the corporate structure and financing of public utility holding companies and their subsidiaries. Under the Federal Power Act, FERC regulates, among other things, the transmission and sale of electricity at wholesale in interstate commerce. FERC has jurisdiction over more than 200 electric utilities, the majority of which are subsidiaries of registered or exempt holding companies.

⁸Service companies provide accounting, administrative, financing, engineering, and other services for utility holding companies and their subsidiaries.

Similarly, state utility commissions establish retail rates and regulate utility transactions, such as dividend payments and security issuances.

SEC coordinates its regulation of public utility holding companies with FERC and state utility commissions on an as-needed basis. SEC and FERC officials told us that they periodically contact each other to exchange information and discuss other issues. For instance, officials from both agencies said they exchange audit findings. (SEC audits service companies of registered holding companies, and FERC audits utilities.) SEC officials similarly said that they contact state commissions, as needed, to obtain and/or exchange information. In a survey we recently conducted, 14 state commissions responded that they rely on SEC to a great or very great extent to regulate exempt holding companies.⁹ Only 7 state commissions said they have ever sought technical or legal assistance from SEC.

FERC and states generally do not regulate diversification by utility holding companies. However, in a 1987 case, FERC successfully asserted jurisdiction over the formation of a new holding company by a utility under its jurisdiction. Under its authority to regulate transactions involving wholesale electricity facilities, FERC determined that it could disapprove the holding company formation or place appropriate conditions on the use of operating funds in cases where it finds sufficient potential for abuse regarding diversification or other activities.

At the state level, 27 commissions responding to our survey said that they do not regulate nonutility-related diversification by exempt utility holding companies. Although 18 of these

⁹We surveyed 51 public utility commissions, including the District of Columbia, on PUHCA-related matters. To date, 43 commissions have responded, but respondents did not necessarily answer all questions.

commissions indicated they could remedy abuses resulting from such activities, 4 commissions said they probably could not, and 5 were uncertain. In addition, our survey results show that 8 of the 27 commissions that do not regulate nonutility diversification rely on SEC to a great or very great extent to regulate exempt holding companies in their states.

FERC and state utility commissions monitor transactions between utilities and their affiliates, including IPP affiliates, but state regulation varies. FERC has scrutinized transactions involving potential affiliate abuse and has rejected several proposed power sales where the potential for abuse existed. In the past several years, the Arizona, California and Michigan utility commissions, among others, have also investigated cases of affiliate abuse involving utility holding company subsidiaries. However, state regulation of affiliate transactions varies. For instance, two state commissions responding to our survey indicated that IPPs are prohibited from selling power to any affiliated utility regulated by the commission. Twelve state commissions responded that they allow IPPs to sell power to affiliated utilities. In addition, the 1990 annual report of the National Association of Regulatory Utility Commissioners shows that state accounting and reporting requirements for affiliate transactions differ. Some states have prescribed systems of accounts and annual report requirements for affiliate transactions, and others have not. Correspondingly, SEC testified earlier this year that state control over operating utilities and their affiliates remains uneven.

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PUHCA is a complex statute that continues to affect the electric utility industry. In accordance with the act, SEC focuses its regulation on registered companies and largely leaves regulation of exempt companies to the states. Our preliminary work shows

that the number of exempt holding companies and their nonutility subsidiaries has increased considerably. In addition, our state survey indicates that the scope and nature of state regulation varies considerably. We plan to develop and report further information on these topics, including state safeguards for protecting electricity consumers from the potential detriments associated with nonutility diversification.

This concludes my prepared statement. I will be glad to answer any questions that you or other Members of the Subcommittee may have.